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Tax Reform in
Developing Countries:
Lessons From Indonesia?

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I. Introduction: The Policy Environment in Indonesia Since 1982

1983 was a year of six major policy adjustments in Indonesia. The last of these was tax reform. Other major policy measures adopted that year included (a) drastic reductions in subsidies for domestic consumption of petroleum products (b) sharp cutbacks in government consumption spending (c) a 30 percent devaluation (d) deep reductions in government spending on capital-intensive industrial projects and (e) major financial reform, including virtual deregulation of interest rates.

The six measures were geared to achieve both short and long run objectives. Five of the measures, including the tax reform were intended to forestall ruinous prospective budget deficits that threatened to arise in a period of declining crude oil prices: prior to 1982, oil provided 2/3 of both taxes and foreign exchange earnings. The long-run objective of these reforms was nothing less than the restructuring of the economy, both through drastic changes in relative prices for traded goods, energy and capital and to reduce economic waste caused by the tax system and by public investments in projects with low social returns. All of the six measures were clearly successful in the short run by whatever standard employed. Two years later, all appear to be working more or less as anticipated.

All six major policy adjustments had two other elements in common. First, they were planned over a considerable period of time, ranging from as short as three months for the financial reform to as long as three years for the tax reform. Second, none of the reforms were imposed or required to qualify for external assistance.

II. The Tax Reform

Planning for tax reform began in January 1981. The cabinet in consultation with the President made their tax reform decisions in October 1983, basing their conclusion on analyses prepared by a technical team over a 2 year period. The reform options were presented to the Parliament in November. Draft legislation based on executive level decisions was accepted by the Parliament in December 1983, and the new laws were adopted on January 1, 1984. The new tax law prescribes the simplest and broadest based tax system yet implemented anywhere. The new, broad based, low-rate income tax entered into force on that date, while the effective date for implementation of the uniform rate comprehensive VAT was set for July, 1984, later postponed to April 1986.

The new laws replace outdated, complicated and unproductive taxes adopted several decades earlier. A complete overhaul of the tax system was required. Use of higher tax rates for revenue purposes or other forms of tinkering with the old system were not viewed as options under the circumstances.

Reform studies that began in early 1981 were strongly focused on base broadening, drastic simplification and rate reduction. While the original impetus for the reform was not fiscal crisis, the new system was intended to be in place in time to supplant much of a projected decline in oil revenues. Other objectives of the reform were more effective income redistribution, elimination of tax barriers to efficiency, a new tax information system and streamlining of tax administration. The Indonesian reform made eclectic use of the lessons from

similar fiscal exercises in Asia, Africa and Latin America and of recent innovations in tax analysis elsewhere, but was tailored to national objectives and constraints. Prospects for long-run success of the reform are as yet unknowable; three factors auguring for some success were (1) the tax reform was introduced as one of a series of six major belt-tightening policy measures all of which gained a measure of public acceptance. (2) None of these measures were imposed or required for external assistance, and (3) Economic growth resumed in 1984, adding to the general public impression that the reforms were, while not uniformly palatable, well considered.

Details of the reformed tax structure are not provided here, but are readily available elsewhere. (See Malcolm Gillis, "Micro and Macroeconomics of Tax Reform", Forthcoming, Journal of Development Economics). Rather, the purpose of this paper is to provide a basis for determining whether the Indonesian experience with fundamental tax reform provides any significant lessons that may be relevant for other countries.

III. Lessons

A) Tax Reform and Fiscal Crisis

The 1983 tax reform in Indonesia, and the approach to same, share some commonalities with similar undertakings elsewhere. Governments everywhere ordinarily embark on major tax reform programs only after the onset of severe fiscal crisis, when unmanageably large deficits have begun to appear. The principal precipitating factor in the enactment of the Indonesian tax reform was also fiscal crisis. However, the Indonesian case is different than most, in that preparations for the tax reform began in early 1981 as a response to the perceived future risks of continued dependence upon oil tax revenues. Only in 1982 was it clear that tax reform would be required to supplant declining oil revenues, rather than ameliorating the worst symptoms of "Dutch Disease." In short, decision-makers did not wait until the "wolf was at the door" before

considering tax reform.

B) Lessons From Other Lessons

In organizing for tax reform, decision-makers made eclectic use of lessons from similar undertakings elsewhere, particularly with regard to the liberal use of specialists other than fiscal economists, and the decision to move directly from selection of reform options to full-blown, coherent draft legislation. The Indonesian undertaking, however, differed from other comprehensive reform efforts in several other respects. A longer time horizon for technical work was allowed than for previous studies in Japan, Venezuela, Liberia, Colombia, and Bolivia. Partly because of the longer time horizon in the Indonesian case, the tax reform program also incorporated a large expansion in overseas training programs for younger tax officials. Finally, the Indonesian effort included tasks not ordinarily covered in tax reform exercises. While issues of reform of tax structure still required a disproportionate share of energies expended in the effort, substantial systematic attention and resources were devoted to such important non-structural issues as reform of tax procedures, the establishment of a computerized tax information system, implementation of reform, and to an extent not commensurate with its importance, tax administration.

C) Focusing Intellectual and Political Firepower

Successful implementation of policy reform, particularly welfare-increasing policy reform, requires that attention be focussed primarily on those issues likely to create the greatest amount of controversy both among the government's political constituency and its critics. Therefore, in tax reform, it is important first to decide what in the tax system is not broken, so that time is not wasted in fixing same. Second, for those components of the system that are broken and which require fixing, the reformers must decide which

require the most analysis and the most intensive lobbying.

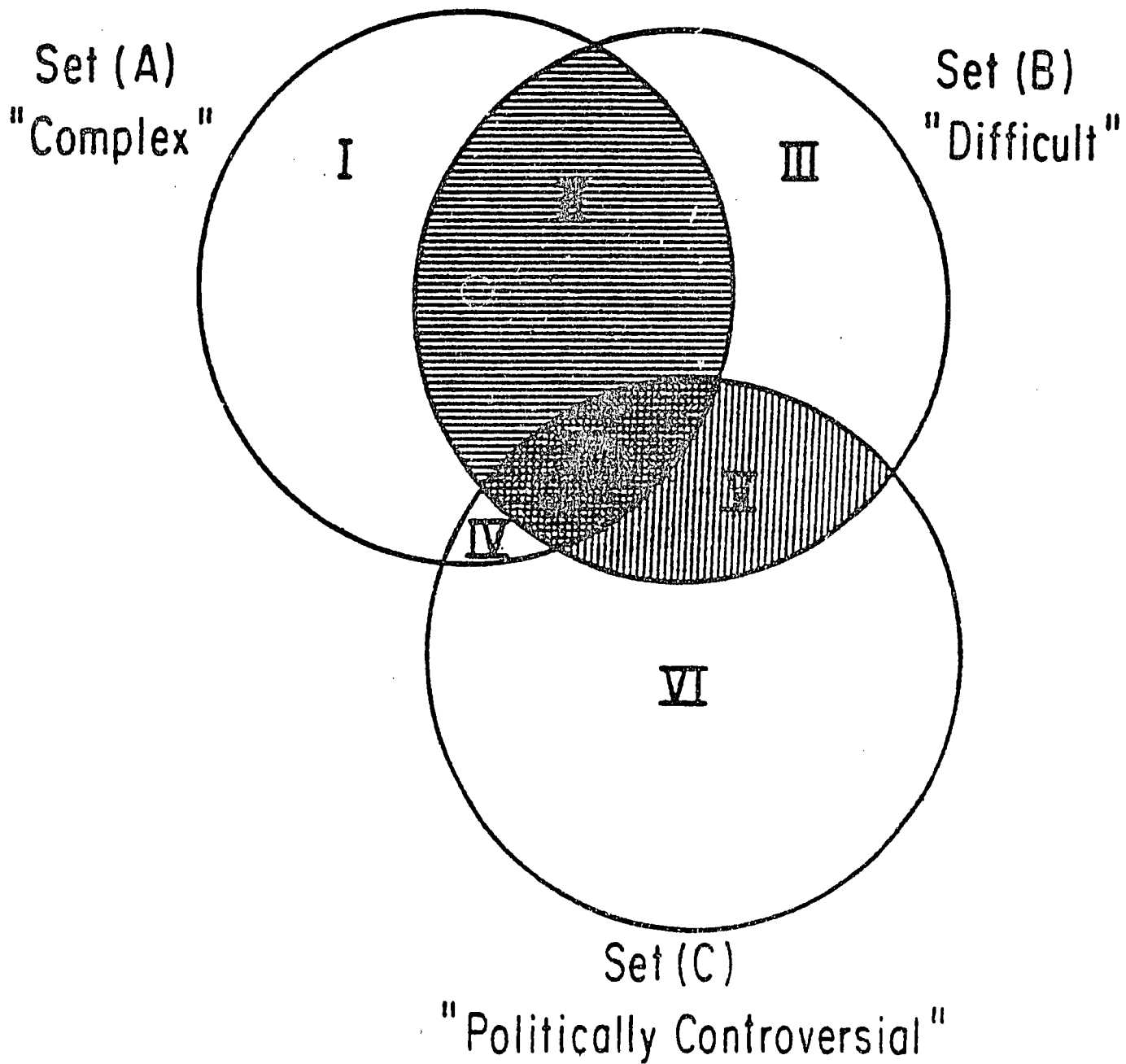
One of the principal lessons of the Indonesian experience with tax reform is the importance of identifying, at the outset, those tax problems which lie at the intersection of three sets of issues: the merely "complex", the "difficult" and the "politically sensitive."

Complex tax issues are those that are not easily understood except by specialized practitioners in law or economics. Such topics include the tax treatment of banks, insurance companies and other financial institutions, most international tax issues (creditability of local taxes against foreign taxes), and most issues in natural resource taxation. While often intricate, complex issues are not necessarily "difficult." Once objectives are specified, widely acceptable solutions can often be readily devised and explained by competent analysts.

While the set of complex issues often intersects the set of difficult issues, there is no union of the two sets. Difficult issues are those for which there is not only a wide divergence in objectives among decision-makers, but also in the premises upon which views are founded. In Indonesia, for example, "difficult" fiscal issues included the question of the efficacy of tax incentives and fine-tuning of taxes in general, almost every issue in taxation of capital income (especially the tax treatment of interest) and the question of inflation-proofing the tax system.

Finally, there are issues that are controversial in a "political" sense. Virtually all issues involving taxation are politically sensitive for someone, but some are particularly so. In Indonesia, examples include taxation of income of civil servants (exempt before 1984), taxation of fringe benefits, tax treaty issues and the efficacy of steeply progressive rates of tax for income redistribution.

HUERISTIC ILLUSTRATION OF ISSUES IN TAX REFORM



Unfortunately, the sets intersect, as in Diagram 1. Several essentially complex tax issues are also "difficult," in the sense I have used that word (area II in diagram). Many difficult issues are also politically controversial (area V), as are a few complex issues (area IV). Finally, there are "impasse" type issues, where all three sets intersect (area VIII). Examples of each type of issue are provided in Table 5.

Type I, or merely complex, issues can often be resolved relatively easily by application of capable specialized talent. Accordingly, most empirical and other work on such questions was postponed until the last stages of work on the reform, to avoid distracting effort and attention from tougher issues. For example, studies on the tax treatment of financial institutions and on most international tax issues were finalized only in July 1983, two years after studies were initiated.

It is particularly important to identify in advance issues of Type II (horizontal shading), V (vertical shading) and above all Type VII (dark area). These combine complexity with difficulty and or political sensitivity.

Decisions about them significantly constrain other decisions, and shape the overall scope and focus of tax reform. Education and research must necessarily be concentrated on issues in those intersections. The questions with impasse potential lay in area VII. There lurked three central issues, the resolution of which would determine not only the tenor of tax reform but its chances for success. Accordingly, a disproportionate share of available talents and energies was deployed on them with some significant success.

Although presentation of prime issues in this fashion did not insure that all these issues were ultimately resolved in a fully consistent manner, it did have the result that decision-makers were made acutely conscious of the nature and details of policy trade-offs involved in tax reform.

D) The Importance of Continuity in Leadership in
Economic Policy-Making

It is difficult to determine the extent to which the above lessons are applicable elsewhere, particularly since the degree of continuity in economic decision-making in Indonesia has few parallels in other countries, and few such decision-makers possess an economic policy track record as successful as the "Berkely Mafia" in Indonesia, a small group of five Ministers.

The officials who pushed through the six major policy reforms in 1983 (including the tax reform) were the same ones who fashioned the spectacularly successful set of policy reforms of 1967-68, which brought both economic stabilization and rapid growth in its wake. This group has learned, over a period of nearly two decades, both from their successes (devaluation in 1971 and 1978, financial liberalization in 1968) and from failures (the Pertamina crisis of 1976, the crisis over renegotiation of oil contracts and inability to curb protectionist excesses in 1972-1984).

Continuity has meant that earlier mistakes in policy implementation tend not to be repeated: the same error is not made twice. In particular this seasoned group of decision-makers has developed an extraordinary sense of policy timing. The severe economic downturn of 1982-83, arising from world recession and slumping oil markets was viewed not as a calamity, but as an opportunity to push through major policy reforms. Prospects for success in such undertakings are enhanced when the past track record is a good one. In the Indonesian case, the track record was not only good, it was long. It was long because it was good, and it was good because it was long.

IV. Outlook

Prospects for success of the 1983 tax reform Indonesia in the long term are still unknowable. But a minimum, complexity of tax laws and regulations can no longer be a reason for Indonesia having among the lowest ratio of income and

sales tax to GDP in the world. Much will depend on the readiness of middle-level tax officials to break with well-imbedded traditions, particularly those involving official, rather than taxpayer, assessment of liabilities and the historically wide latitude allowed for exercise of official discretion in tax administration.

Although assessment of the effects of the tax reform would be decidedly premature in 1985, the results of the other components of the 1983 set of belt-tightening policy measures did exceed original expectations and this has improved prospects for long-term success in tax reform. Consumer demand for energy products (and budgetary subsidies for them) responded sharply to higher prices; official international reserves almost doubled within nine months after the devaluation; real GDP growth rose from almost zero in 1982 to nearly 5 percent in 1983. Domestic inflation by 1984 was barely higher than world inflation, in spite of large increases in the prices of energy and imported goods. Finally, time deposits in the organized financial system rose by 80 percent within nine months of the financial reform, and are still rising.

Most of the other 1983 policy adjustments required little in the way of administrative effort for their implementation, operating as they do primarily through the price system. This was clearly true for reform of domestic energy subsidies, the devaluation and deregulation of interest rates. The impact of these adjustments is difficult to evade. Tax reform is, however, another matter. While incentives for tax evasion may be lower and the risks of discovery higher under the reformed tax system, long-standing traditions of non-compliance dating from the Dutch Colonial period may be altered only slowly, and only then if the machinery of tax administration responds as required.

But in terms of revenues, the results of the reform have up to now clearly exceeded expectations. Although the new rudimentary value-Added tax was finally implemented only in April 1985, revenues from the new levy are running

well ahead of projections. Income tax revenues are growing only about as fast as expected, but the income tax was never intended to furnish more than 1/3 of the revenue goals of reform.

Still, the jury is still out on the Indonesian tax reform of 1983. With appropriate administrative reforms, the new tax system may prove to be one of the most successful ever introduced in the Third World. If in the end the reform proves a failure, it will not be for all the same reasons that tax reform as failed elsewhere. The reform was carefully planned and well-timed. It involved much more than mere changes in tax structure: fundamental improvements were made in tax procedures and the taxpayer information system. Rather, if this reform founders, it will be largely because of a failure to reduce the scope for rent-seeking behavior in the tax administration itself.